EFRAG
European Financial Reporting Advisory Group

Comments should be submitted by 28 March 2011 to Commentletters@efrag.org

[XX April 2011]
International Accounting Standards Board
30 Cannon Street
London
EC4M 6XH
United Kingdom

Dear Sir / Madam

Re: Supplementary Document *Financial Instruments: Impairment*

On behalf of the European Financial Reporting Advisory Group (EFRAG), I am writing to comment on the Supplementary Document *Financial Instruments: Impairment* ('the Supplementary Document') that the IASB issued on 31 January 2011. This letter is submitted in EFRAG's capacity of contributing to IASB's due process and does not necessarily indicate the conclusions that would be reached by EFRAG in its capacity as advisor to the European Commission, on endorsement of the definitive IFRS in the European Union and European Economic Area.

In its comment letter on the IASB Exposure Draft *Financial Instruments: Amortised Cost and Impairment* (the 'November 2009 proposals') and in its comment letter on the FASB Exposure Draft *Accounting for Financial Instruments*, EFRAG supported the following approach:

- The amortised cost and impairment model for financial assets should be based on an expected loss approach founded on the conceptual principles proposed by the IASB proposals. An entity's estimate of impairment losses should reflect all existing information including expected future developments and forecasts of future events and economic conditions.

- At initial recognition, expected credit losses should be allocated over the life of the financial asset. As a result, net interest revenue would reflect the compensation paid for credit losses expected on initial recognition.

- Gains and losses resulting from changes in estimates of future cash flows should be recognised in the period of the re-estimate, to the extent that the change relates to current or prior periods (i.e. incurred losses should be recognised immediately).

- Operational simplification is crucial to making the proposals workable.

We welcome the IASB's efforts to find operational solutions for the difficulties identified in respect of the model exposed in the November 2009 proposals. EFRAG agrees with the IASB that the most challenging operational issue relates to the implementation of the expected cash flow approach to open portfolios of financial assets, and supports the development of a simplified approach to the expected cash flow model based on the separate allocation ('decoupling') of interest revenues and expected credit losses.

EFRAG strongly believes that a consistent accounting treatment should be applied to similar economic events. Therefore, we believe that all financial assets carried at amortised cost should be measured using a consistent impairment model. We accept that in some cases application of a simplified approach is appropriate where a strict application of the impairment model would not be practicable. However, such a simplification should not introduce new concepts and should result in a reasonable approximation of the original impairment model.

We note that the Supplementary Document introduces new concepts (e.g. the 'floor' and the notions of 'good book' and 'bad book') into the debate, rather than exclusively focussing on simplification of the expected cash flow model. We further note that this separate consultation on the development of an impairment approach for open portfolios adds to the fragmentation of the deliberation process and the due process, making it all the more difficult to assess these proposals in their full context. For these reasons, we believe that a 60-day comment period is insufficient and believe that constituents should be given additional time to assess the proposals in detail. We would also urge the IASB to engage in field-testing these new concepts to assess their impact.

EFRAG welcomes the IASB's and the FASB's efforts to develop a common approach to the accounting for the impairment of financial assets. However, we strongly believe that the converged approach should represent a high-quality proposal and we remain to be persuaded that the common approach proposed in the Supplementary Document for open portfolio provides an acceptable simplification of the approach that we supported in our comment letter to the November 2009 proposals.

In particular, we believe that an impairment model should reflect the link between the pricing of the asset and the expected credit losses, and we have a number of concerns on the use of the floor and the concept of 'foreseeable future'. We understand that the IASB approach to the 'decoupling' (i.e. without a floor) does not take account of front-loaded loss emergence patterns and we agree that the approach should be modified to mitigate the risk of inadequate provision balances for such portfolios. However, we do not believe that a floor is the only way to deal with this issue. Therefore, we encourage the IASB to explore alternative approaches that take account of all available information in the determination of the allowance.

Finally, we note that the Supplementary Document is insufficiently clear about the benefits of the common approach to users and preparers. Also, it does not adequately explain the rationale behind the mechanics and the impacts of a number of aspects of the common model. We believe that these clarifications are needed to help constituents understand how the proposed model provides an acceptable simplification to the original proposals.

If you wish to discuss our comments further, please do not hesitate to contact Chiara Del Prete, Patrick Mommens or me.

Yours sincerely,

Françoise Flores
EFRAG, Chairman

Appendix A

Notes to constituents

Background and scope of this consultation

1 *The IASB developed its original proposals on impairment of financial instruments in its Exposure Draft issued in November 2009. The FASB developed different proposals in its Exposure Draft on financial instruments that it issued in May 2010.*

2 *The model proposed by the IASB (the expected cash flow model) was designed to reflect initial expected credit losses as part of determining the effective interest rate, in order to reflect the substance of the lending transactions and the link that exists between interest revenue and credit losses.*

3 *EFRAG issued its comment letter on the IASB Exposure Draft on 28 June 2010. EFRAG was supportive of the objective of the proposed model and of the measurement principles in the Exposure Draft. However, significant concerns were raised about some aspects of those principles, including operational difficulties in the application. That comment letter also presented the view of the majority of EFRAG members that a change in estimate of cash flows relating to future periods is more appropriately recognised in those future periods (partial catch-up). This approached differed from what was proposed in the Exposure Draft which called for immediate recognition in profit or loss (full catch-up).*

4 *The FASB's Exposure Draft sets out a comprehensive approach to financial instruments classification and measurement, impairment and hedge accounting. Given that the fair value of financial assets would be the primary basis for reporting the entity's financial position, the FASB's impairment model was primarily focused on the allocation of impairment losses from other comprehensive income to profit or loss. The FASB developed an impairment model that would recognise all expected credit losses at the first reporting date rather than over time.*

5 *EFRAG issued its comment letter on the FASB Exposure Draft on 28 September 2010. In that comment letter, EFRAG:*

(a) *observed that the IASB and FASB models were not directly comparable, because the FASB's objective was to establish a model for recognition and measurement of credit impairment of financial assets measured at fair value with qualifying changes in fair value recognised in other comprehensive income.*

(b) *formulated its recommendations to both the FASB and IASB on how to meet best the objective of achieving a single high-quality standard on financial instruments. In particular,*

(i) *The amortised cost and impairment model for financial assets should be based on an expected loss approach founded on the conceptual principles proposed by the IASB. An entity's estimate of impairment losses should reflect all existing information including expected future developments and forecasts of future events and economic conditions.*

(ii) *EFRAG agreed with the IASB's proposal that credit losses expected at initial recognition should be allocated over the life of the financial asset. As a result, net interest revenue would reflect the compensation paid for credit losses expected on initial recognition. Gains and losses* *resulting from changes in estimates of future cash flows should be recognised in the period of the re-estimate, to the extent that the change relates to current or prior periods.*

6 *The comments received by the IASB on its November 2009 proposals highlighted support for the measurement principles, but also indicated significant operational difficulties in applying those principles, especially in the context of open portfolios. In its redeliberations, which started in July 2010, the IASB developed an approach for open portfolios on the basis of the advice received from the Expert Advisory Panel and outreach activities undertaken after the publication of the November 2009 proposals.*

7 *While starting from different objectives in their respective projects, the FASB and the IASB started in October 2010 to jointly redeliberate the impairment model, with the common primary objective of reaching a converged solution for impairment of financial assets. This work resulted in the joint publication of the Supplementary Document* Financial Instruments: Impairment *on 31 January 2011.*

8 *As explained by the boards (in paragraphs BC32 to BC55 of the Supplementary Document), the proposed common approach, based on a time-proportional allocation of the expected losses, was the result of a redeliberation effort aimed at retaining, to the maximum extent possible, some of the outcomes of applying the November 2009 Exposure Draft. These included the link between pricing of financial assets and expected credit losses, recognition of the changes in loss estimates, deferral of the initial expected credit losses. As explained in paragraphs IN12, BC32 and BC66 of the Supplementary Document, the introduction of the floor (i.e. requiring that the credit allowance covers at least the expected losses for the foreseeable future) was the compromise for combining the two different impairment approaches of the boards. The floor addresses the FASB's primary concern about the adequacy of the impairment allowance.*

9 *The Supplementary Document requests views (in Questions 1 to 11) on a converged model for the recognition of expected credit losses in the context of open portfolios only. The boards are addressing this issue separately because it represents the area of greatest operational complexity in the proposals for amortised cost and impairment.*

10 *As explained in paragraph IN20 of the Supplementary Document, all other aspects of the November 2009 proposals (e.g. the approach to closed portfolios and individual items, the methods for measuring credit losses, the objective of amortised cost and the interest recognition) will be redeliberated separately from the Supplementary Document.*

11 *Question 12of the Supplementary Document request views on the IASB's approach which is the same as the common approach but without the floor. Question 13 requests views on the FASB's approach which requires recognition of expected credit losses for the foreseeable future in the first reporting period. Those approaches were developed during the boards individual redeliberations, before they agreed on a converged solution.*

12 *In assessing the proposals in the Supplementary Document we have considered the proposed common model for impairment of open portfolios of financial assets in isolation. We note, however, that there are likely to be differences in the scope of application of the common model because of divergences between the IASB and the FASB approaches to the classification of financial instruments. Those issues have not been specifically considered here.*

Comparison between the common approach, the January 2011 IASB approach and the November 2009 IASB approach

13 *The model proposed in the Supplementary Document applies to portfolios of financial assets with the following characteristics:*

(a) *according to the internal risk management processes, the financial assets are managed for receiving regular payments from the debtor; and*

(b) *they are managed on an open portfolio basis. That is, every period new financial assets are added to or removed from the portfolio. This may be because of transfers from or to other portfolios, originations, write-offs, sales, purchases, and repayments.*

14 *By its nature, an open portfolio does not have a predefined maturity, but only an estimated life that reflects the weighted average expected life of the individual loans in the portfolio at the reporting date (see also paragraphs B3 and B9 of the Supplementary Document).*

15 *Under the common approach, the level of the impairment allowance for open portfolios needs to be determined as follows:*

(a) *For 'good book' loans the allowance is the higher of:*

(i) *the time-proportional expected credit losses; and*

(ii) *the credit losses expected to occur within the foreseeable future;*

(b) *For 'bad book' loans the allowance is the entire amount of expected credit losses.*

16 *As explained by the board in paragraph BC32 of the Supplementary Document, the IASB's preferred approach was a good/bad book model without the floor (i.e. allowance equal to the time proportional amount of the remaining lifetime expected credit losses for good book loans). When loans are considered bad (i.e. the entity's credit risk management objective changes from receiving regular payments to recovery of all or a portion of the financial asset), the full amount of expected losses is recognised immediately in profit or loss. That model was considered by the board to be a simplified approach of an expected credit loss model, whose objective would be to reflect the underlying economics of a lending transaction (i.e. maintaining the link between the pricing of the financial assets and the expected credit losses).*

17 *EFRAG understands that, compared to the original conceptual model in the November 2009 proposals, this approach is a simplified partial catch-up approach (i.e. deferral to the future of some of the changes in credit loss estimates that relate to future periods), something that EFRAG was proposing in its comment letters of June 2010 on the IASB Exposure Draft and of September 2010 on the FASB Exposure Draft.*

18 *The board explains (paragraph BC61 of the Supplementary Document) that one of the reasons for agreeing on the common approach as proposed in the Supplementary Document (including the foreseeable future floor) was the concern that under the IASB approach, the allowance balance might be inadequate for asset classes with losses that tend to occur early in the lives of the financial assets (i.e. front-loaded loss emergence patterns). Paragraph BC74 of the Supplementary Document illustrates two possible alternative approaches proposed by a minority of IASB members that were not supportive of the converged common approach.*

Appendix B

EFRAG's responses to the questions in the Supplementary Document *Financial Instruments: Impairment*

Question 1

Do you believe the approach for recognition of impairment described in this supplementary document deals with this weakness (ie delayed recognition of expected credit losses)? If not, how do you believe the proposed model should be revised and why?

Notes to constituents

19 *The IASB identified as one of the main weakness of the impairment model under IAS 39* Financial Instruments – Recognition and Measurement *the failure of the model to account for expected credit losses from the time they are expected. The model proposed in the Supplementary Document aims to address this weakness in the context of open portfolios of financial assets.*

EFRAG's response

In our view, the proposals will most likely result in earlier recognition of credit losses thereby addressing the mentioned perceived weakness in IAS 39 – that is the delayed recognition of credit losses.

We remain to be persuaded that the proposed model still meets the objectives of the impairment model as defined by the November 2009 proposals

20 In our letter dated 28 June 2010, EFRAG supported the direction of the proposals in the 2009 Exposure Draft *Amortised Cost and Impairment* (the 'November 2009 proposals').

21 In particular, we supported the IASB's objective of developing an alternative to the incurred loss impairment model for financial assets that uses more forward-looking information about credit losses and aims to eliminate the delay in recognition of credit losses on financial assets.

22 We believe that the amortised cost and impairment model for financial assets should be based on an expected loss approach and that an entity's estimate of impairment losses should reflect all existing information including expected future developments and forecasts of future events and economic conditions.

23 We understand that the approach proposed in the Supplementary Document relies on forward-looking information about credit losses and that an entity would not need to delay recognition of credit losses until objective evidence of impairment existed. However, as explained in our responses to Questions 3, 4, 5, 9 and 10 below, we remain to be persuaded that the proposed model still meets the objectives of the impairment model as defined by the November 2009 proposals.

24 Before being able to provide a conclusive response to the question, we would ask the IASB to engage in field-testing with constituents to determine the degree to which the proposals address the mentioned perceived weakness of IAS 39, and to determine to what extent the proposed model still meets the objective of the November 2009 proposals. We believe that field-testing of the proposals in necessary because their suitability probably depends greatly on the loan loss patterns and the availability of forward-looking information.

Question 2

Is the impairment model proposed in the supplementary document at least as operational for closed portfolios and other instruments as it is for open portfolios? Why or why not?

Although the supplementary document seeks views on whether the proposed approach is suitable for open portfolios, the boards welcome any comments on its suitability for single assets and closed portfolios and also comments on how important it is to have a single impairment approach for all relevant financial assets.

Notes to constituents

25 *From the responses to the 2009 Exposure Draft, the IASB learned that the greatest operational concerns for constituents related to the application of the model within the context of open or dynamic portfolios of financial assets. The scope of the document is therefore limited to such open portfolios.*

26 *The proposed model was derived from the integrated expected cash flow model proposed in the 2009 Exposure Draft. However, in addition to the proposals of the Expert Advisory Panel, the model represents a further compromise reached by the IASB and FASB. One possible implication of this is that the amortised cost category of financial assets will be subject to more than one impairment model.*

27 *EFRAG notes that one of the objectives of the IAS 39 replacement project was to simplify the accounting for financial instruments. The common proposals require the level of the impairment allowance for open portfolios to be determined as follows:*

(a) *For 'good book' loans the allowance is the higher of:*

(i) *the <u>time-proportional amount</u> which can be computed by applying the ratio of the weighted average age of the portfolio to the weighted average life to the expected losses for the remaining weighted average expected life of the portfolio; and*

(ii) *the <u>floor</u>, which are the credit losses expected to occur within the foreseeable future (i.e. a period of no less than twelve months).*

(b) *For 'bad book' loans the allowance is the entire amount of expected credit losses.*

28 *In addition to these, entities would possibly apply a separate approach for individual items based on the November 2009 proposals, another for loan commitments and financial guarantees and yet another for short-term trade receivables (as they are specifically scoped out of the Supplementary Document). We note that the IASB has not yet decided on the direction it intends to take in relation to short-term trade receivables, loan commitments and financial guarantee contracts.*

EFRAG's response

EFRAG supports a consistent impairment model for all financial assets carried at amortised cost. However, any simplification of that model should result in a reasonable approximation of the original model.

29 EFRAG strongly believes that a consistent accounting treatment should be applied to similar economic events. Therefore, we believe that all financial assets carried at amortised cost should be measured using a consistent impairment approach. However, we accept that in some cases application of a simplified approach is appropriate where a strict application of the guidance would not be practicable. Nevertheless, such a simplification should not introduce new concepts and should result in a reasonable approximation of the original impairment approach.

30 In principle, requiring the use of different approaches in different situations would not result in a simplification of the guidance and might be difficult to implement and maintain. Furthermore, users may also find it difficult to understand the information resulting from the different approaches applied to a single class of financial assets.

31 For those reasons, EFRAG supports a consistent approach to measure the impairment for all financial assets carried at amortised cost, but only to the extent that it is practicable to apply such an approach.

32 We refer to our comment letter dated 28 June 2010 where we support a scope exemption for those short-term financial assets that arise in the normal course of business that do not carry contractually stated interest and that arise from the revenue generating transactions that an entity engages in. Paragraph 1 of the Supplementary Document scopes out ‘short-term receivables without a stated interest rate that are so short-term that the effect of discounting for the time value of money is immaterial’. EFRAG is concerned that the scope exclusion is not sufficiently clear.

33 For instance, we agree that short-term credit card receivables that do not bear interest, because they are paid when due, still have a stated interest rate and are within the scope of the proposals. However, this is not sufficiently clear from the wording of the Supplementary Document. We therefore recommend the IASB to clarify the scope exclusion.

Question to constituents

34 Do constituents believe that a consistent impairment approach for the determination of impairment allowances for financial assets carried at amortised cost is preferable to multiple approaches? Why or why not?

35 Do constituents believe that the proposals are at least as operational for financial assets carried at amortised cost other than those managed within open portfolios (e.g. assets managed in closed portfolios and individual assets)? Why or why not?

36 Do constituents believe that the proposals are operational for portfolios other than loan portfolios (e.g. bond portfolios?)

Question 3

Do you agree that for financial assets in the ‘good book’ it is appropriate to recognise the impairment allowance using the approach described above? Why, or why not?

Question 4

Would the proposed approach to determining the impairment allowance on a time-proportional basis be operational? Why, or why not?

Question 5

Would the proposed approach provide information that is useful for decision-making? If not, how would you modify the proposal?

Notes to constituents

37 *For the purpose of the proposed impairment model, financial assets managed within open portfolios are placed in two groups: the good and bad book based on an entity's credit risk management practices.*

38 *As explained above, for the good book, the impairment allowance in the statement of financial position is calculated as the higher of:*

(a) *the time-proportional expected credit losses; and*

(b) *the credit losses expected to occur in within the foreseeable future.*

39 *In this model the impairment expense in profit or loss is determined, by definition, as a balancing number. The impairment allowance in the statement of financial position is utilised by activity during the reporting period (e.g. charge-offs or reversals), the impairment expense in profit or loss is determined as that amount that brings the impairment allowance to a level that is the higher of (1) the time-proportional expected credit losses and (2) the credit losses expected to occur in within the foreseeable future. Therefore, the impairment expense in profit or loss is not necessarily recognised in proportion to interest revenue (i.e. it is not defined as a direct function of interest revenue).*

40 *Paragraph BC84 of the Supplementary Document notes that FASB members – who prefer an impairment model that would always recognise expected credit losses for the foreseeable future period at the reporting date (i.e. a floor) – believe that 'in an open pool setting, the time-proportional approach requires a proportion of remaining lifetime expected future credit losses (for the 'good book') to be recognised at the end of the reporting period. In this way, the time-proportional amount is similar to the foreseeable future amount, because both represent some proportion of the remaining lifetime expected credit losses for the open pool being recognised at the reporting date'.*

41 *The allowance account represents the expected credit losses ('EL') recognised from initial recognition of the financial assets on a pro rata basis over the remaining life of the portfolio by multiplying the EL with the ratio 'Weighted Average Age/Weighted Average Life' for the portfolio, unless the EL for the foreseeable future exceed the allocated amount (floor). In applying the time-proportional allocation, entities are allowed to take into account the time value of money (annuity approach). When financial assets are, in accordance with the entity's internal risk management, transferred to the bad book, the entire amount of the related EL is recognised.*

42 *For the bad book, the lifetime expected credit losses are provided for at the time when the loan or portfolio of loans is designated as such.*

43 *EFRAG staff performed a first assessment of the quantitative impact of the proposals on the level of impairment allowance and understood that the level of the impairment allowance and the annual additions to the allowance are sensitive to the following:*

(a) *The pattern of the actual losses (e.g. front-loaded, back-loaded or exceptional one-off losses);*

(b) *The length of the period defined as the 'foreseeable future' (i.e. this determines the level of the floor);*

(c) *Changes in expectations, which may lead to a catch-up in the floor and possibly the time-proportional expected credit losses; and*

(d) *Interactions between:*

  (i) *The time-proportional expected credit losses and the floor (i.e. depending on the factors under (a) and (b) above, the model alternates between the two impairment approaches);*

  (ii) *Good book and bad book portfolios (i.e. classification of a loan into the bad book will result in a requirement to provide for all expected credit losses without a time-proportional or foreseeable future restriction).*

The relative importance of each of the factors listed above depends on an entity's particular fact pattern.

44 *The IASB approach was developed with an intention to approximate the results of the expected cash flow model and achieve a form of decoupling (i.e. separate allocation of interest revenues and credit losses). Some argue that the decoupling proposed in the IASB Approach (i.e. the model in the Supplementary Document without a floor) is not necessarily a reasonable approximation of the November 2009 credit-adjusted effective interest rate approach. In particular:*

(a) *Paragraph B8(a) of the Supplementary Document requires the impairment allowance to be calculated 'by multiplying the entire amount of credit losses expected for the remaining life of the portfolio by the ratio of the portfolio's age to its expected life (i.e. a straight-line approach using either a discounted or undiscounted estimate)'. This means that for a portfolio of loans in which (1) credit losses are the same every year and (2) the average age of the loans is half their expect life, an entity would already need to provide for half of the remaining expected losses. In other words, in the second half of the life of the portfolio, the entity would only need to recognise an impairment charge equal to half of the remaining expected losses.*

(b) *Under the time-proportional approach the impairment expense in profit or loss is not recognised in proportion to interest revenue (i.e. it is not defined as a direct function of interest revenue). As noted in paragraph BC84 of the Supplementary Document, 'the time-proportional amount is similar to the foreseeable future amount, because both represent some proportion of the remaining lifetime expected credit losses for the open pool being recognised at the reporting date'.*

EFRAG's response

EFRAG supports the efforts of the IASB to develop an operable and simplified approach to the expected cash flow model.

We agree that the IASB approach should be modified to mitigate the risk of inadequate provision balances for portfolios with front-loaded loss emergence patterns. However, we believe that a floor is not the only way to deal with this issue and we encourage the IASB to further explore alternative approaches.

45 We support the efforts of the IASB to develop an operable and simplified approach to the expected cash flow model, based on the separate allocation ('decoupling') of interest revenues (which are allocated using the effective interest rate as currently defined in IAS 39) and expected credit losses (both initial and revised).

46 EFRAG agrees with an approach whereby expected losses are not necessarily attributed to specific periods. It is consistent with the approach suggested by EFRAG in its response to the November 2009 proposals whereby expected credit losses are recognised to the extent that they relate to periods up to and including the reporting date. We note that the Expert Advisory Panel suggested a similar approach.

47 Furthermore, in relation to the time-proportional mechanism, we welcome the introduction of a partial catch-up approach (i.e. deferral to the future of some of the changes in credit loss estimates that relate to future periods), as proposed in our 28 June 2010 comment letter.

48 Based on our preliminary assessment, we remain to be persuaded that the proposed model represents an acceptable simplification of the original proposals.

49 In particular, we disagree with the proposals to set a floor at a level reflecting credit losses expected to occur within the foreseeable future to the extent that such expected losses are priced into the expected future interest income. In fact, we believe that an impairment model should reflect the link between the pricing of the asset and the expected credit losses.

50 We understand that, as explained by the board (paragraph BC74 of the Supplementary Document), the time-proportional approach may not create a sufficient allowance in an early loss emergence scenario. As the IASB approach (i.e. without a floor) does not take account of front-loaded loss emergence patterns, we agree that the approach should be modified to mitigate the risk of inadequate provision balances for such portfolios.

51 We do not believe that a floor is the only way to deal with this issue and encourage the IASB to explore alternative approaches. For example, as the IASB discussed in its December 2010 meeting, this issue could be addressed by requiring a time-proportional approach based on expected loss profiling that ensures that an allowance is built up faster. In our view, entities need to consider all available information in the determination of the time-proportionate allowance. Therefore, if an entity expects losses to materialise in the foreseeable future it should be allowed to accelerate the build-up of the allowance balance to reflect this information. If, however, an entity expects to have built-up sufficient provisions by the time those losses are expected to materialise we see no reason for requiring that entity to recognise an immediate loss. We stress, however, that such a method should not result in a negative allowance that defers incurred losses to future periods (i.e. incurred losses should be recognised immediately).

52 We have a number of further concerns regarding the proposals that are discussed in our response to Question 9.

Questions to constituents

53 Do constituents believe that requiring a time-proportionate approach that allows loan loss profiling can deal with the issue of an early loss emergence scenario?

54 Do constituents believe the proposed approach is operational? If not, would you recommend a different approach?

55 Would the proposed approach for determining the impairment allowance be operational outside the financial services industry?

56 Would the proposed approach provide decision useful information? If not, how would you modify the proposals?

Question 6

Is the requirement to differentiate between the two groups (ie ‘good book’ and ‘bad book’) for the purpose of determining the impairment allowance clearly described? If not, how could it be described more clearly?

Question 7

Is the requirement to differentiate between the two groups (ie ‘good book’ and ‘bad book’) for the purpose of determining the impairment allowance operational and/or auditable? If not, how could it be made more operational and/or auditable?

Question 8

Do you agree with that proposed requirement to differentiate between the two groups (ie ‘good book’ and ‘bad book’) for the purpose of determining the impairment allowance? If not, what requirement would you propose and why?

Notes to constituents

57 *Paragraph 3 of the Supplementary Document proposes the following principle for distinguishing between good book and bad book portfolios:*

> *It is no longer appropriate to recognise expected credit losses over a time period if the collectability of a financial asset, or group of financial assets, becomes so uncertain that the entity’s credit risk management objective changes for that asset or group thereof from receiving the regular payments from the debtor to recovery of all or a portion of the financial asset.*

58 *Regarding the distinction between the good book and bad book portfolios, paragraph BC75 of the Supplementary Document notes that ‘the IASB members who prefer this approach acknowledge that some are concerned about the lack of comparability between entities that may have similar portfolios, but use different judgement. Also, they acknowledge that because of the judgement involved, some are concerned that the approach creates the potential for earnings management. These IASB members believe that these concerns equally apply to any impairment approach involving judgement (including an approach that recognises losses expected to occur in the foreseeable future).’*

EFRAG’s response

EFRAG agrees that an approach based on the two groups is appropriate. Given the diversity in credit risk management practices, the proposed disclosures are essential to ensure a measure of comparability between entities.

The IASB should ensure that the guidance is also appropriate for entities outside the financial services industries.

59 EFRAG agrees that an approach based on the two groups is appropriate, as it is aligned with the way entities manage their loan portfolios.

60 We observe that in practice there is diversity in credit risk management practice and in the definitions of good book and bad book portfolios. Therefore, we agree that the disclosures proposed in paragraph Z15(a) of the Supplementary Document are essential to ensure a measure of comparability between entities.

61 We note that the proposed guidance is drafted from the perspective of a financial institution. It presumes that all entities have fairly sophisticated credit risk management activities. While this may be true for those large banking institutions who manage the majority of their financial assets on an open portfolio basis, it does not consider the vast majority of IFRS issuers who do not have such sophisticated systems. EFRAG supports, as stated in our response to Question 2, the use of a consistent approach to impairment for all assets carried at amortised cost. If it is decided to apply this approach to items other than open portfolios of assets we encourage the IASB to amend the text accordingly.

62 To achieve this, we suggest an approach that first sets out the general principle that all entities can apply and relate to. The application guidance should then assist entities of differing complexity in applying the principle. To achieve this we suggest redrafting paragraph 2.2 as follows:

> Whether it is appropriate to recognise expected credit losses over a time period depends on the degree of uncertainty about the collectability of a financial asset. It is no longer appropriate to recognise expected credit losses over a time period if the collectability of a financial asset, or group of financial assets, becomes so uncertain that the entity's ~~credit risk management~~ objective changes for that asset or group thereof from receiving the regular payments from the debtor to recovery of all or a portion of the financial asset.

In order for this change to be effective we also suggest redrafting paragraphs B3 and B4 as follows:

> B3 An entity shall differentiate the two groups ~~on the basis of its internal credit risk management~~ <u>as follows</u>:
>
> (a) … [unchanged]
>
> (b) ~~Entities that~~ <u>Other entities</u> do not manage credit risk using an approach that differentiates the management of financial assets depending on the uncertainty about their collectibility ~~in a way similar to the principle in paragraph 3 must still differentiate their financial assets into two groups for the purpose of determining the impairment allowance in accordance with paragraph 2. For example, an entity might comply with that principle.~~ <u>These entities might comply with the principle in paragraph 2.2</u> using criteria such as days past due, whether the expected return is below the risk-free interest rate, or when management identifies loans as doubtful (sometimes also considered by an entity as 'problem loans').

Questions to constituents

63 Are the definitions of 'good book' and 'bad book' consistent with the existing practice for credit risk management? Why or why not?

64 Are these definitions an appropriate driver for the application of the two different approaches to the recognition of expected credit losses? Why or why not? How would you suggest to amend these definitions?

Question 9

The boards are seeking comment with respect to the minimum allowance amount (floor) that would be required under this model. Specifically, on the following issues:

(a) Do you agree with the proposal to require a floor for the impairment allowance related to the 'good book'? Why or why not?

(b) Alternatively, do you believe that an entity should be required to invoke a floor for the impairment allowance amount related to the 'good book' only in circumstances in which there is evidence of an early loss pattern?

(c) If you agree with a proposed minimum allowance amount, do you further agree that it should be determined on the basis of losses expected to occur within the foreseeable future (and no less than twelve months)? Why or why not? If you disagree, how would you prefer the minimum allowance to be determined and why?

(d) For the foreseeable future, would the period considered in developing the expected loss estimate change on the basis of changes in economic conditions?

(e) Do you believe that the foreseeable future period (for purposes of a credit impairment model) is typically a period greater than twelve months? Why or why not? Please provide data to support your response, including details of particular portfolios for which you believe this will be the case.

(f) If you agree that the foreseeable future is typically a period greater than twelve months, in order to facilitate comparability, do you believe that a 'ceiling' should be established for determining the amount of credit impairment to be recognised under the 'floor' requirement (for example, no more than three years after an entity's reporting date)? If so, please provide data and/or reasons to support your response.

Question 10

Do you believe that the floor will typically be equal to or higher than the amount calculated in accordance with paragraph 2.1(a)(i)? Please provide data and/or reasons to support your response, including details of particular portfolios for which you believe this will be the case.

Notes to constituents

65 *Initially the IASB and the FASB pursued different objectives in their impairment proposals, which caused them to favour different proposals for the recognition of expected credit losses. The boards undertook joint redeliberations with the objective of reaching a compromise due to the importance of reaching a common solution.*

66 *In order to bridge the gap between the two models, the boards proposed to require that the model developed by the IASB to be modified to introduce a minimum amount ('floor') for the allowance amount for the group for which expected credit losses are recognised over time (i.e. good books). This modification would set the total allowance for impairments (for both the good and bad books) at an amount that would always at least equal expected credit losses at the time they are expected to occur within the 'foreseeable future' (being a period of not less than one year).*

67 *Some IASB members do not support the inclusion of the floor because it does not reflect properly of the economics of lending transactions. However, they*

acknowledge that for loans for which expected credit losses are recognised over time in an early loss pattern scenario, the time-proportional approach may not create an allowance balance sufficient to cover the expected losses before they occur.

EFRAG's response

We believe that a floor is not the only way to deal with the risk of inadequate provision balances for portfolios with front-loaded loss emergence patterns, and we encourage the IASB to further explore alternative approaches.

We do not believe that the Basis for Conclusions adequately explains the rationale behind the mechanics and the impacts of the common model.

We are also concerned that the floor might result in the immediate recognition of all the expected losses for good books of short term loans.

68 As explained in our response to Questions 3, 4 and 5 above, we welcome the IASB's efforts to develop a simplified approach to the expected cash flows model in order to make it operable for open portfolios. However, on our initial assessment, we remain to be persuaded that the proposed model represents an acceptable simplification of the original proposals.

69 As noted in paragraph IN5 of the Supplementary Document, the primary objective of IASB's original proposals was 'to reflect initial expected credit losses as part of determining the effective interest rate, as the IASB believed that this was more reflective of the economic substance of lending transactions'. In our opinion, the Basis for Conclusions is insufficiently clear about the benefits of the common approach to users and preparers. Also, it does not adequately explain the rationale behind the mechanics and the impacts of the following aspects of the common model, such as:

(a) why the time-proportional calculation of expected credit losses recognises the particular fraction of expected future losses that it does (paragraph B8 of the Supplementary Document);

(b) why an entity is given a choice between a time-proportional calculation based on a discounted or undiscounted straight-line approach and an annuity approach (paragraph B8 of the Supplementary Document);

(c) the difference between (1) the information that needs to exist to predict expected future losses and (2) the 'reasonable and supportable information' that needs to exist to support specific projections of events and conditions for the purpose of calculating the floor;

(d) how the time-proportional calculation is expected to interact with the floor; and

(e) why a floor is still needed for the good book portfolio, given that all expected credit losses need recognised in respect of any bad loans identified with a portfolio.

We believe that these clarifications are needed to help constituents understand how the proposed model provides an acceptable simplification to the original proposals.

70 We have the following concerns about the inclusion of a 'floor' in the proposed model:

(a) We do not believe that a floor appropriately reflects the economics of lending transactions because it ignores the link between the pricing of financial assets and expected credit losses (e.g. it gives rise to day-one credit losses for newly originated financial assets and underestimates (overestimates) the net return on new (older) assets in an open portfolio). In addition, we understand from our initial consultations that in the case of short-term portfolios the allowance would be set at the level of the floor.

(b) In all other instances in IFRSs where the standards require assets or liabilities to be accounted for 'at the higher of' one measurement basis or another basis, both bases are defined in their own right and can each be interpreted in a meaningful way. However, in these proposals it has not been made clear how a user might interpret the value of assets that are accounted for at amortised cost minus a 'floor'-based impairment allowance.

(c) As this would be an entirely new concept in IFRSs, we believe that if the board were to retain this approach, it should explain what the 'floor' represents in terms of performance measurement.

71 In addition, we have concerns about the use of the term 'foreseeable future' and what that means. In particular:

(a) We question whether the notion of a floor can be applied consistently in a way that provides comparable information. As noted in paragraph BC86 of the Supplementary Document, 'the lack of any clear articulation of what the foreseeable future period means is likely to result in significant divergence in practice'.

(b) We are concerned that a floor based on the foreseeable future would result in the immediate recognition of an impairment allowance on performing portfolios that have an average life of between 12 months and 3 years, effectively providing for impairment losses on these portfolios as if they were comprised entirely of bad book loans.

(c) The flexibility in selecting and changing the period seen as the foreseeable future may result in earnings management and a loss of comparability in information from one year to another and across different entities.

(d) The length of the foreseeable future can change with the phases of a business cycle or reacting to changes in the conditions of the financial markets. An increase in the market volatility might result in higher uncertainty attached to the forecast for the foreseeable future and the length of this period needs to be shortened.

72 If the IASB were to retain the floor in the model, we suggest that it develop further guidance and disclosures that ensure this concept is consistently applied in a transparent manner that users of financial statements are able to understand and compare.

73 As noted in our response to Questions 3, 4 and 5, we do not believe that a floor is the only way to deal with the risk of inadequate provision balances early loss emergence scenarios and we encourage the IASB to explore alternative approaches.

Question to constituents

74 Do you believe that the floor will typically be equal to or higher than the amount calculated according to paragraph 2.1(a)(i)? For which particular types of portfolios do you expect it to be lower?

Question 11

The boards are seeking comment with respect to the flexibility related to using discounted amounts. Specifically, on the following issues:

(a) Do you agree with the flexibility permitted to use either a discounted or undiscounted estimate when applying the approach described in paragraph B8(a)? Why or why not?

(b) Do you agree with permitting flexibility in the selection of a discount rate when using a discounted expected loss amount? Why or why not?

Notes to constituents

75 *In determining the time-proportional expected credit loss an entity can either:*

(a) *multiply the entire amount of credit losses over the weighted remaining life of the portfolio by the ratio of the portfolio's weighted age to its weighted expected life; or*

(b) *convert the entire amount of expected credit losses over the weighted remaining life of the portfolio into annuities on the basis of the weighted expected life of the portfolio and accumulating these annuities for the portfolio's weighted age.*

76 *If the entity applies the annuity approach described above, it may use as the discount rate any reasonable rate between the risk-free rate and the effective interest rate. This flexibility is intended to eliminate some difficulties in applying the proposals.*

EFRAG's response

EFRAG does not agree with the proposed flexibility from a conceptual perspective.

We would like to see guidance developed that would require an entity to determine the most appropriate rate, unless impracticable, before resorting to a standardised proxy.

77 EFRAG does not agree with the proposed flexibility from a conceptual perspective.

78 IFRS generally require cash flows that will occur in the future to be discounted. This requirement is based on the presumption that time value of money should be considered in a measurement based on future cash flows. To this extent, we would support the use of discounted amounts in determining the allowance amount. However, considering the practical difficulties, we would urge the IASB to develop guidance that would require an entity to use discounted cash flows (even if they were calculated on a simplified basis) unless it is impracticable to do so.

79 While we understand the concerns of constituents regarding the calculation of the effective interest rate at a portfolio level, the proposals will in our view result in diversity in practice that would reduce comparability. It is not clear how an entity would decide whether the risk-free rate or effective interest rate, or some rate in between, should apply.

80 In addition, there is the practical concern that a risk-free rate determined today may well be higher than the effective interest rate on a loan that was originated

several years ago. Again here it is not quite clear what that would mean in terms of the interpretation of the resulting financial information.

81 Rather than providing a range of possible rates, we would like to see guidance developed that would require an entity to determine the most appropriate rate, unless impracticable, before resorting to a standardised proxy.

82 We note the IASB has decided to maintain the IAS 39 guidance on determining the effective interest rate. This is consistent with our assumption that the rationale for discounting is based on expected losses representing a reduction in cash flows included in the effective interest rate calculation. In our view, the portfolio effective interest rate or an approximation thereof would be the most appropriate rate. We understand the conceptual and practical difficulties in calculating an effective interest rate for an open portfolio. However, we believe that a proxy thereof could be determined and applied in most instances.

Question to constituents

83 Are constituents aware of specific instances where it would be impracticable to discount expected credit losses even if it were calculated on a simplified basis? If so, please provide examples of such situations in addition to the explanation of why it would be impracticable.

84 Are constituents aware of instances where it would be impracticable to determine the effective interest rate, or an approximation thereof, for particular portfolios of financial assets carried at amortised cost? If so, please provide examples of such situations in addition to the explanation of why it would be impracticable.

Question 12

Would you prefer the IASB approach for open portfolios of financial assets measured at amortised cost to the common proposal in this document? Why or why not? If you would not prefer this specific IASB approach, do you prefer the general concept of the IASB approach (ie to recognise expected credit losses over the life of the assets)? Why or why not?

Notes to constituents

85 *The IASB favoured the common approach without the floor (i.e. to recognise expected credit losses over the life of the financial assets). This approach, in their view, was conceptually similar to the original proposals.*

EFRAG's response

We are supportive of the general concept underlying the November 2009 proposals and we support the development of a simplified approach, based on the separate allocation ('decoupling') of interest revenues and expected credit losses. However, we remain to be persuaded that the IASB approach provides an acceptable simplification.

86 We are supportive of the general concept underlying the original IASB approach (i.e. to recognise expected credit losses over the life of the assets) and welcome the introduction of a partial catch-up approach, as proposed in our 28 June 2010 comment letter. We prefer an approach that:

(a) maintains a link between the pricing of financial assets and the expected losses. As actual losses occur over the life of a portfolio of financial assets, recognising expected credit losses over the expected life better reflects the economics of the lending transactions; and

(b) results in immediate recognition of expected losses for the remaining life of a financial asset when it is transferred to the bad book.

87 Since we understand that operational simplification is crucial to making those proposals workable, we support the development of a simplified approach to the expected cash flow model, based on the separate allocation ('decoupling') of interest revenues (which are allocated using the effective interest rate as currently defined in IAS 39) and expected credit losses (both initial and revised).

88 As explained in our response to Questions 3, 4 and 5 above, we remain to be persuaded that the decoupling proposed in the IASB approach (i.e. the model in the Supplementary Document without a floor) provides an acceptable simplification of the original proposals and we encourage the IASB to explore alternative approaches for mitigating the drawbacks identified in the IASB approach.

Question 13

Would you prefer the FASB approach for assets in the scope of this document to the common proposal in this document? Why or why not? If you would not prefer this specific FASB approach, do you prefer the general concept of this FASB approach (ie to recognise currently credit losses expected to occur in the foreseeable future at or after the first reporting date after initial recognition of the financial assets)? Why or why not?

Notes to constituents

89 *The model preferred by the FASB does not distinguish between the good and bad books. Rather, their preferred model recognises the expected credit losses for the foreseeable future for all financial assets carried at amortised cost at or after the first reporting date after initial recognition of the financial assets. For the purpose of their model, the foreseeable future is that period for which specific reasonable and supportable projections can be made. Essentially, this is a similar amount to the floor amount in the main proposals.*

EFRAG's response

EFRAG does not support the FASB model because it does not reflect the economics of lending transactions. In addition, we have concerns on about the application of the concept of 'foreseeable future'.

90 As explained in our response to Question 9, EFRAG does not support the recognition of all credit losses expected to occur in the foreseeable future at or after the first reporting date after initial recognition of the financial assets. This approach does not reflect the economics of lending transactions (i.e. it does not maintain the link between the pricing of financial assets and expected credit losses). In addition, we also note in that response our concerns about the application of the concept of 'foreseeable future'.

91 We recognise, however, that the FASB model is operationally less complex to apply because it does not rely on a good book/bad book split or a time-proportional calculation in combination with a floor.

Other issues

92 EFRAG has noted in the past that it is important for the IASB to consider the development of IFRS 9 as a whole. In our view, this is important not only because of the interaction between the different phases, but also because the availability of new information may lead to a reconsideration of earlier decisions. This phase proposes that an open portfolio of financial assets carried at amortised cost could have frequent additions and disposals. In our view, this may sit uneasily with the guidance provided in B4.1.3 of IFRS 9 (phase 1). There, an entity can only classify a portfolio of assets if sales or disposals are infrequent. We suggest that the IASB ensures that requirements throughout the comprehensive IFRS 9 are consistent before its finalisation.

Questions to constituents

93 The G-20 Finance Ministers and Central Bank Governors called for convergence towards a single set of high-quality, global, independent accounting standards on loan-loss provisioning and the impairment and valuation of financial assets. They encouraged the IASB to take account of the Basel Committee guiding principles on IAS 39 and the report of the Financial Crisis Advisory Group.

94 To understand the possible broader impacts of the proposals in the Supplementary Document, EFRAG would like constituents to comment on whether or not they believe the proposals:

(a) result in useful information to users in general;

(b) promote a level playing field;

(c) are pro-cyclical;

(d) give rise to regulatory issues or concerns; or

(e) have other macroeconomic effects.

Appendix C

Questions IASB-only re-deliberations

Question 14Z

Do you agree that the determination of the effective interest rate should be separate from the consideration of expected losses, as opposed to the original IASB proposal which incorporated expected credit losses in the calculation of the effective interest rate? Why or why not?

Notes to constituents

95 *A large majority of respondents to the IASB's 2009 Exposure Draft and the Expert Advisory Panel (EAP) highlighted that, as a result of operating separate accounting and credit risk systems, there were strong operational challenges associated with applying an integrated effective interest rate to net cash flow estimates. Based on responses received and in particular the suggestions made by the EAP to address the main operational challenges, the IASB decided to 'decouple' the computation of the effective interest rate from the consideration of credit losses. Under the new proposals, the calculation of the effective interest rate would stay the same as required today by IAS 39 while expected credit losses are allocated over the life of financial assets using a separate approach (see also Questions 1-10 above).*

EFRAG's response

EFRAG believes that for open portfolios the effective interest rate should be determined separately from the expected losses, this to ensure that the method is operational.

96 In our response to the November 2009 proposals, we commented that an integrated effective interest rate approach could be operationally burdensome and that we would be supportive of a decoupled effective interest rate calculation that approximates the allocation profile achieved by the November 2009 proposals. EFRAG believes that for open portfolios the effective interest rate should be determined separately from the expected losses, this to ensure that the method is operational.

97 As explained in our response to Question 12, based on our preliminary assessment we remain to be persuaded that the proposed IASB approach (i.e. the proposed model without the 'floor') represents an acceptable simplification of the original proposals.

Question 15Z

Should all loan commitments that are not accounted for at fair value through profit or loss (whether within the scope of IAS 39 and IFRS 9 or IAS 37) be subject to the impairment requirements proposed in the supplementary document? Why or why not?

Question 16Z

Would the proposed requirements be operational if applied to loan commitments and financial guarantee contracts? Why or why not?

Notes to constituents

98 *While many loan commitments are outside the scope of IAS 39 and IFRS 9, the IASB is seeking views as to whether a single standard should apply to accounting for expected losses on both loans and loan commitments. The IASB considers that this might be appropriate because entities often manage both loans and loan commitments using the same business model and accounting systems, irrespective of whether the credit exposure is accounted for in accordance with IAS 39 or IAS 37* Provisions, Contingent Liabilities and Contingent Assets*.*

99 *Regarding financial guarantee contracts, the IASB asked in its Exposure Draft* Insurance Contracts *whether such contracts should be brought within the scope of the proposed IFRS on insurance contracts. While the IASB has not yet re-deliberated this issue, it decided to ask at this stage whether the proposed impairment model would be operational for financial guarantee contracts.*

EFRAG's response

We support the view that the same impairment approach should apply for both loans and loan commitments since they are often managed within the same business strategy.

We recommend the IASB take a more comprehensive approach that also deals with revolving loans.

Regarding financial guarantee contracts, we believe it is better to retain the current option in paragraph 2(e) of IAS 39.

100 We support the view that the same impairment model should apply for both loans and loan commitments since they are often managed within the same business strategy.

101 Regarding financial guarantee contracts, we believe that the common proposals could be applied to the extent that they do not result in the recognition of negative assets.

102 In its comment letter on the Exposure Draft *Insurance Contracts*, EFRAG noted that 'financial guarantee contracts', as issued by banks, and 'credit insurance contracts', as issued by insurers, could both meet the definition of an insurance contract. We acknowledge that it is generally desirable to have similar accounting for similar contracts. However, the existing guidance that only requires insurers to apply insurance accounting has worked well in practice. Therefore, given the practicability concerns regarding the application of the insurance contracts proposals by non-insurers, we believe it is better to retain the current option in paragraph 2(e) of IAS 39.

Question to constituents

103 Do constituents believe that it would be operational to apply the proposed impairment requirements to all loan commitments that are not accounted for at fair value through profit as well as financial guarantee contracts? Why or why not?

Question 17Z

Do you agree with the proposed presentation requirements? If not, what presentation would you prefer instead and why?

Notes to constituents

104 *Based on the proposed changes in the impairment approach, the new presentation proposals contain two line items (gross interest revenue and impairment losses). These proposals are based on the IASB's view that under the simplified impairment approach, that does not differentiate between initial estimates of credit losses and changes in those estimates, it is no longer possible to present separately the effect of allocating the initial credit loss estimates and changes in those estimates. Under the November 2009 impairment model, four line items (gross interest revenue, the portion of initial expected credit losses allocated, net interest revenue (subtotal of the first two items) and impairment losses) were proposed.*

EFRAG's response

While we remain to be persuaded that the proposed approach represents an acceptable simplification of the original proposals, we accept the presentation proposals in this document in the context of the common model.

105 EFRAG supported the presentation requirements of the November 2009 proposals for all assets carried at amortised cost other than short-term trade receivables. In our view, the proposals provided valuable information about the extent to which interest revenue represented compensation for credit losses. Short-term trade receivables do not include an interest component and therefore we did not support the presentation for those financial assets.

106 In assessing the common proposals, it is clear that similar information cannot be derived anymore because the amount of expected credit losses recognised will be the higher of (1) the time-proportional expected credit losses and (2) the credit losses expected to occur within the foreseeable future (which shall be no less than twelve months after the reporting date).

107 As explained in our responses to Questions 3, 4, 5, 9 and 10, based on our preliminary assessment, we remain to be persuaded that the proposed model represents an acceptable simplification of the original proposals. However, in the context of the common model we accept that the original presentation proposals are no longer achievable and agree that the proposals in this document are appropriate under the circumstances.

Question 18Z

(a) Do you agree with the proposed disclosure requirements? If not, what disclosure requirement do you disagree with and why?

(b) What other disclosures would you prefer (whether in addition to or instead of the proposed disclosures) for the proposed impairment model and why?

Notes to constituents

108 *To allow users of financial statements to evaluate the effects of the credit risk of financial instruments on an entity's financial position and performance under the new impairment proposals, the IASB is proposing (additional) disclosures about the (minimum) allowance amount, inputs and assumptions used for determining credit loss estimates, information about an entity's internal credit risk management, and how the good and bad book are managed.*

109 *The November 2009 Exposure Draft included a requirement to disclose the development of the credit loss allowance over time and the cumulative write-offs (i.e. a 'credit loss triangle'). This information was considered to provide significant information for users in assessing the performance of the entity in its credit risk management. The Supplementary Document proposes a disclosure that compares the expected credit loss estimates with accrual outcome of credit losses ('back-testing') if an entity already performs this type of testing. In its recent re-deliberations the IASB has tentatively decided:*

(a) *to replace the 'credit loss triangle' with 'back-testing' information, because many entities use open portfolios and calculate expected losses and assess actual outcomes at the portfolio level; and*

(b) *to delete the disclosure of vintage information (origination and maturity), which was to be used in conjunction with the 'credit loss triangle', considering that for open portfolios it would be very difficult to obtain such vintage information.*

EFRAG's response

EFRAG supports the proposed disclosure, but urges the IASB to consider the proposals in the Supplementary Document in the context of the existing disclosure requirements in IFRS 7 and to ensure that the level of guidance remains consistent and balanced across topics.

110 EFRAG believes that disclosures play a fundamental role in complementing financial information derived from applying the decoupled effective interest rate as well as the proposed impairment model. The proposed model implies application of more judgement than IAS 39. To increase transparency and comparability, we believe that the disclosures should help users to understand the effects of credit risk of financial instruments on an entity's financial position and performance.

111 We believe that the proposed disclosures with regard to the allowance account, expected credit loss estimates and credit risk management aim to achieve this. We agree that these categories are relevant to provide an insight into an entity's credit risk management activities and the effect of those activities on the entity's financial position and performance.

112 Having said that, we are concerned about the requirement to disclose for five annual periods the information listed in paragraph Z8 of the Supplementary Document. In general, we believe that the requirement to disclose a time series does not automatically increase the informational value of disclosures and therefore we suggest the IASB to re-assess the need for this requirement.

113 Furthermore, we believe that the proposals should put more emphasis on ensuring that information is disclosed at an appropriately disaggregated level. Also, we wonder whether the disclosures should include information on when an entity

considers financial assets irrecoverable (write-off trigger), as there are current significant differences in practice between jurisdictions.

114 Finally, we observe that in its recent deliberations, the IASB has tentatively decided to remove the concept of 'non-performing loan' and instead require disclosure of the movement during the period in the nominal amount of financial assets that are 90 days past due, but not included in the bad book. We also find it difficult to understand how the proposals would interact with the disclosure requirements of IFRS 7 *Financial Instruments: Disclosures* (e.g. disclosures about incurred losses) as well as proposed disclosure requirements as part of other phases of the IAS 39 replacement project (e.g. vintage disclosures as part of the November 2009 proposals). However, we urge the IASB to consider the proposals in the Supplementary Document in the context of the existing disclosure requirements in IFRS 7 and to ensure that the level of guidance included in the disclosure standard remains consistent and balanced across topics.

Question to constituents

115 Do constituents believe that the proposed disclosure requirements are appropriate?

Question 19Z

Do you agree with the proposal to transfer an amount of the related allowance reflecting the age of the financial asset when transferring financial assets between the two groups? Why or why not? If not, would you instead prefer to transfer all or none of the expected credit loss of the financial asset?

EFRAG's response

We agree that when a (group of) financial asset(s) is transferred between the two books, the amount that is transferred between the impairment allowances shall be determined in accordance with the weighted average age and life of the transferred financial asset(s).

116 We agree that when a (group of) financial asset(s) is transferred between the two books, the amount that is transferred between the impairment allowances shall be determined in accordance with the weighted average age and life of the transferred financial asset(s). This approach should facilitate the assessment of the disclosed reconciliation information of the allowance accounts for good and bad books.